FILED

No. 97 1075 DEC 24 1997

OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

AMERITECH CORPORATION, *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

CONDITIONAL CROSS-PETITION OF REGIONAL BELL COMPANIES FOR A WRIT OF CERTIORARI

LAURENCE H. TRIBE
JONATHAN S. MASSEY
1575 Massachusetts Avenue
Cambridge, Massachusetts 02138
(617) 495-4621

WALTER H. ALFORD
WILLIAM B. BARFIELD
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Suite 1800
Atlanta, Georgia 30367
(404) 249-2600
Counsel for BellSouth Corporation

MARK L. EVANS *
MICHAEL K. KELLOGG
AUSTIN C. SCHLICK
SEAN A. LEV
JONATHAN T. MOLOT
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1301 K Street, N.W.
Suite 1000 West
Washington, D.C. 20005
(202) 326-7900
Counsel for Ameritech Corporation, Bell Atlantic Corporation, BellSouth Corporation, and SBC Communications Inc.

* Counsel of Record

[Additional Counsel Listed on Inside Cover]

December 24, 1997

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

KELLY R. WELSH
JOHN T. LENAHAN
AMERITECH CORPORATION
30 South Wacker Drive
Chicago, Illinois 60606
(312) 750-5000

KENNETH S. GELLER
DONALD M. FALK
MAYER, BROWN & PLATT
2000 Pennsylvania Ave., N.W.
Suite 6500
Washington, D.C. 20006
(202) 463-2000

STEPHEN M. SHAPIRO
THEODORE A. LIVINGSTON
JOHN E. MUENCH
MAYER, BROWN & PLATT
190 South LaSalle Street
Chicago, Illinois 60603
(312) 782-0600

Counsel for
Ameritech Corporation

JAMES R. YOUNG
EDWARD D. YOUNG III
MICHAEL E. GLOVER
BELL ATLANTIC CORPORATION
1320 North Court House Road
Eighth Floor
Arlington, Virginia 22201
(703) 974-2944

Counsel for
Bell Atlantic Corporation

JAMES D. ELLIS
PATRICIA DIAZ DENNIS
ROBERT M. LYNCH
LIAM S. COONAN
MARTIN E. GRAMBOW
DAVID F. BROWN
SBC COMMUNICATIONS INC.
175 E. Houston, Room 1254
San Antonio, Texas 78205
(210) 351-3737

DURWARD D. DUPRE
MICHAEL J. ZPEVAK
SOUTHWESTERN BELL
TELEPHONE COMPANY
One Bell Plaza, Room 2401
Dallas, Texas 75202
(214) 464-5550

STEPHEN B. HIGGINS
JAMES W. ERWIN
THOMPSON COBURN
One Mercantile Center
Suite 3500
St. Louis, Missouri 63101-1693
(314) 552-6054

Counsel for
SBC Communications Inc.

QUESTIONS PRESENTED

The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, requires incumbent local telephone companies to sell their retail services to competitors at wholesale rates, so that companies without any local network facilities of their own can enter the local telephone business by offering those services for resale. 47 U.S.C. § 251(c)(4). Incumbents must also make available pieces of their existing networks, known as "unbundled network elements," so that new entrants can fill in gaps in their networks. *Id.* § 251(c)(3). Congress established different pricing standards for these discrete entry methods. An incumbent must sell its end-to-end retail services for resale at a wholesale discount off of the retail rate; it must sell access to the individual elements of its physical network on an unbundled basis at the cost of providing those elements plus a reasonable profit. *Id.* § 252(d)(1), (3).

The questions presented in this Conditional Cross-Petition—which is conditioned on a grant of Question Two in the petition of the Federal Communications Commission ("FCC") in No. 97-831—are whether the FCC violated the statute's express distinction between resale and unbundled network elements by requiring telephone companies:

(1) to sell to competitors without any existing facilities of their own access to all the network elements associated with a particular retail service, not at the statute's discount rate for resale, but at the cost-based rate reserved for competitors with some of their own facilities who purchase access to individual network elements; and

(2) to sell as unbundled network elements under section 251(c)(3) finished retail services such as caller ID and call forwarding, when the same services must be made available for resale under section 251(c)(4).

LIST OF PARTIES AND AFFILIATES

The parties to the proceedings in the United States Court of Appeals for the Eighth Circuit are reproduced at Pet. App. 1a-4a, 73a-78a, and 92a in proceeding 97-826.

Pursuant to Supreme Court Rule 29.6, the parties to this brief submit the following statement concerning parent companies and non-wholly owned subsidiaries:

Ameritech Corporation has no parent companies and no non-wholly owned subsidiaries.

Bell Atlantic Corporation has no parent companies. It owns the following subsidiaries having securities in the hands of the public: Bell Atlantic-Delaware, Inc., Bell Atlantic-Maryland, Inc., Bell Atlantic-New Jersey, Inc., Bell Atlantic-Pennsylvania, Inc., Bell Atlantic-Virginia, Inc., Bell Atlantic-Washington, D.C., Inc., Bell Atlantic-West Virginia, Inc., Bell Atlantic Financial Services, Inc., New York Telephone Company, New England Telephone and Telegraph Company, NYNEX Credit Company, NYNEX Capital Funding Company. In addition Bell Atlantic has the following non-wholly owned subsidiaries: One Parkway, Inc., ICA Foreign Financial, Inc., Chesapeake Directory Sales Company, Atlantic West B.V., Grupo Iusacell, S.A. de C.V., Bell Atlantic New Zealand Holdings, Inc., PrimeCo Personal Communications, L.P., Washington, D.C. SMSA Limited Partnership, New York SMSA Limited Partnership, Upstate Cellular Network, Orange County Poughkeepsie MSA Limited Partnership, Pittsfield Cellular Telephone Company, Allentown SMSA Limited Partnership, Reading SMSA Limited Partnership, Pittsburgh SMSA Limited Partnership, Pennsylvania RSA No. 6(II) Limited Partnership, Columbia Cellular Telephone Company, Anderson Cellular Telephone Company, Las Cruces Cellular Company, TELE-TV, TELE-TV Media, L.P., TELE-TV Systems, L.P., NYNEX Master Lease Partners, Global Directory Services Company,

MEDIATEL spol. s.f.o., Zlate Stranky MEDIATEL spol. s.r.o., Greek Directory Services Company, NIMCO Commercial Societe Anonyme of Publication of Directories and of Information Services, Polish Directory Services Company, NYNEX Worldwide Directories Company, Kipling Associates L.L.C., NYNEX International (Asia) Ltd., and Gibraltar NYNEX Communications Limited.

BellSouth Corporation has no parent companies. BellSouth Corporation's non-wholly owned subsidiaries are 1155 Peachtree Associates, InfoVentures of Atlanta, Beijing Ji Tong—BellSouth Communication & Information Engineering Co., Ltd., Compania de Radiocommunicaciones Moviles S.A., Telcel Celular C.A., Tele 2000, S.A., RAM Mobile Data Belgium, S.C.S., RAM Mobile Data C.V., RAM Mobile Data Limited, BellSouth Carolinas PCS, L.P. (d/b/a BellSouth Mobility DCS), Bloomington Cellular Telephone Company, Chattanooga MSA Limited Partnership, Decatur RSA Limited Partnership, Florida RSA #2B (Indian River) Limited Partnership, Georgia RSA No. 1 Limited Partnership, Georgia RSA No. 2 Limited Partnership, Georgia RSA No. 3 Limited Partnership, Gulf Coast Cellular Telephone Company, Huntsville MSA Limited Partnership, Lafayette MSA Limited Partnership, Los Angeles Cellular Telephone Company, Louisiana RSA No. 7 Cellular General Partnership, MCTA, Muncie Cellular Telephone Company, Inc., Orlando SMSA Limited Partnership, Richmond Cellular Telephone Company, and Terre-Haute Cellular Telephone Company, Inc.

SBC Communications, Inc., which has shares outstanding in the hands of the public, is the parent company of Southwestern Bell Telephone Company and Southwestern Bell Yellow Pages, Inc. SBC Communications Inc. has the following non-wholly owned subsidiaries which have shares or partnership interests outstanding in the hands of the public: Abilene SMSA Limited Partnership, Amarillo SMSA Limited Partnership, Buffalo Telephone Company,

Cellular Mobile Corporation, Champaign CellTelco, Dallas SMSA Limited Partnership, Decatur Cellular Telephone Company, Inc., Eastern Missouri Cellular Limited Partnership, Gainesville Development Associates Limited, Gary Cellular Telephone Company, Kansas City SMSA Limited Partnership, Lubbock SMSA Limited Partnership, McAllen/Edinburgh SMSA Limited Partnership, Midland-Odessa SMSA Limited Partnership, Missouri RSA 8 Limited Partnership, Missouri RSA 9 B1 Limited Partnership, Oklahoma City SMSA Limited Partnership, Oklahoma RSA 3 Limited Partnership, Oklahoma RSA 9 Limited Partnership, PTF/FCLC Associates (LP), PTF/GECC (California) Associates (LP), San Antonio SMSA Limited Partnership, SBMS Cellular Telecommunications Bloomington, Inc., SBMS Cellular Telecommunications Springfield, Inc., S.T.L.M. Programming Services Limited, St. Joseph SMSA Limited Partnership, Texas RSA 9B4 Limited Partnership, Texas RSA 10B1 Limited Partnership, Texas/ Illinois Cellular Limited Partnership, Topeka SMSA Limited Partnership, Washington/Baltimore Cellular Limited Partnership, Wichita SMSA Limited Partnership, and Worcester Telephone Company.

On April 1, 1997, SBC Communications Inc., Pacific Telesis Group ("PAC"), and SBC Communications (NV) Inc., a wholly owned subsidiary of SBC Communications Inc., completed an agreement and plan of merger by the means of which PAC and SBC Communications (NV) Inc. were merged into PAC, and PAC became a wholly owned subsidiary of SBC Communications Inc. PAC, formerly a publicly held corporation, and its wholly owned subsidiaries, Pacific Bell and Nevada Bell, provide telecommunications services subject to the general jurisdiction of the Federal Communications Commission.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
LIST OF PARTIES AND AFFILIATES	ii
TABLE OF AUTHORITIES	vii
OPINIONS BELOW	1
JURISDICTION	2
STATUTORY PROVISIONS INVOLVED	2
STATEMENT OF THE CASE	2
1. The 1996 Act	4
2. The FCC's Regulations	8
3. The Eighth Circuit's Decision	9
4. Petitions for Certiorari	12
REASONS FOR GRANTING THE CONDITIONAL CROSS-PETITION	13
I. IF THE COURT REVIEWS THE EIGHTH CIRCUIT'S HOLDING ON COMBINATIONS OF NETWORK ELEMENTS, IT SHOULD ALSO CONSIDER WHETHER COMPETITORS WITHOUT ANY FACILITIES MAY PURCHASE END-TO-END NETWORK ELEMENTS AS A SUBSTITUTE FOR RESALE	14
II. IF THE COURT REVIEWS THE RELATIONSHIP BETWEEN NETWORK ELEMENTS AND RESALE, IT SHOULD ALSO CONSIDER WHETHER COMPETITORS MAY ORDER RETAIL VERTICAL SERVICES AS NETWORK ELEMENTS	22

TABLE OF CONTENTS—Continued

Page

CONCLUSION 25

APENDIX A:

Excerpts from First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 (1996):

¶¶ 10-15 ..... 1a
¶¶ 258-264 ..... 5a
¶¶ 410-413 ..... 9a
¶¶ 618-624 ..... 13a

TABLE OF AUTHORITIES

Cases — Page

Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997) 1

Agency Orders

First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, *modified on reconsideration*, 11 FCC Rcd 13042 (1996), *vacated in part, Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *modified*, 1997 U.S. App. LEXIS 28652 (8th Cir. Oct. 14, 1997), *petitions for cert. pending*, 97-826, 97-829, 97-830, 97-831 1

Memorandum Opinion and Order, *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as Amended, to Provide In-Region, InterLATA Services, in Michigan*, CC Dkt. No. 97-137, FCC 97-298 (rel. Aug. 19, 1997) 15

Notice of Proposed Rulemaking, *GTE Sprint Communications Corp., et al., Joint Petition for Expedited Rulemaking*, 50 Fed. Reg. 50316 (1985) .. 5

Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776 (1997) 6, 9, 23

Third Order on Reconsideration and Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 12 FCC Rcd 12460 (1997) 20

Statutes and Legislative Materials

28 U.S.C. § 1254(1) 2

47 U.S.C. § 153(29) 12, 22, 24

47 U.S.C. § 153(46) 24

47 U.S.C. § 251(c)(2) 4

47 U.S.C. § 251(c)(3) .....*passim*

47 U.S.C. § 251(c)(4) 5, 22, 23

47 U.S.C. § 251(c)(6) 18

47 U.S.C. § 252(d)(1) 7

47 U.S.C. § 252(d)(3) 8

TABLE OF AUTHORITIES—Continued

Page

47 U.S.C. § 271 11
H.R. Rep. No. 104-204 (1995) 4, 5, 8, 19
Hearings Before the Telecommunications and Finance Subcommittee, House Commerce Committee, 104th Cong., 1st Sess. (May 10, 1995) 16
S. Conf. Rep. No. 104-230 (1996) 4, 5, 19
S. Rep. No. 104-23 (1995) 19

Other Materials

Telecomunications Reports (Nov. 10, 1997) 15
Transcript, AT&T Investment Community Meeting (Mar. 3, 1997) 14, 15

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

No. ———

AMERITECH CORPORATION, *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

CONDITIONAL CROSS-PETITION OF REGIONAL BELL COMPANIES FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The principal opinion of the Court of Appeals for the Eighth Circuit in *Iowa Utilities Board v. FCC* (Pet. App. 1a-67a),[1] as amended by the court's order on rehearing (Pet. App. 69a-72a), is reported at 120 F.3d 753. The Federal Communications Commission ("FCC") order reviewed by the Eighth Circuit—First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* (excerpts of which are reproduced at Pet. App. 131a-337a)—is reported at 11 FCC Rcd 15499 (1996).

---

[1] References to "Pet. App." are to the Appendix filed by petitioner AT&T in No. 97-826. The Appendix to this Conditional Cross-Petition is cited as "Cross-Pet. App."

JURISDICTION

The judgment of the court of appeals in *Iowa Utilities Board* was entered on July 18, 1997. A subsequent order in that case, granting rehearing in part and denying rehearing in part, was issued on October 14, 1997. Pet. App. 69a-72a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Relevant portions of the Communications Act of 1934, as amended by the Telecommunications Act of 1996, appear at Pet. App. 93a-130a.

STATEMENT OF THE CASE

The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act" or "Act"), opened local telephone markets by making available three distinct paths of competitive entry—"the construction of new networks, the use of unbundled elements of the incumbent's network, and resale." Pet. App. 137a. On this point, all parties are in agreement. *See* FCC Pet. 5; MCI Pet. 4-5; AT&T Pet. 7. What petitioners do not acknowledge, however, is that these distinct entry paths are governed by distinct substantive provisions that include different pricing regimes and involve different costs and risks.

In implementing the Act, the FCC issued a set of rules enabling competitors without any existing facilities not only to purchase an incumbent local exchange carrier's ("incumbent LEC's") retail service at the statutory wholesale rate *but also* to purchase, at the *different* statutory rate for unbundled network elements, the already-assembled end-to-end facilities needed to provide retail service. In AT&T's words, this gave competitors "[a]nother way to resell" the incumbent LEC's services.

Determining that these FCC rules would collectively "obliterate" statutory distinctions between facilities-based

entry and resale, the Eighth Circuit invalidated the rules that would have required incumbents to provide network elements to their competitors on a pre-combined basis. Pet. App. 52a-53a, 71a. The court then determined that this step limited the practical effect of requiring incumbents to sell end-to-end facilities to their competitors, and it accordingly found that so long as end-to-end network elements are delivered on an *unbundled*—that is, physically and economically separated—basis, the FCC's decision to require incumbents to deliver the entire array of network elements needed to provide a finished service was permissible under the 1996 Act. *Id.* at 53a-58a.

In asking this Court to revisit the court of appeals' decision regarding pre-assembled combinations of individual elements, the petitioners seek artificially to limit the question presented to the Court by ignoring the FCC rule requiring incumbents to sell all the network elements used to provide a retail service. *Id.* at 245a-46a. This rule allows competitors to duplicate the incumbent's service without building any part of a telephone network or paying the wholesale rate for the incumbent's service. The Eighth Circuit allowed that rule to stand, but only after it declared invalid the FCC's rules requiring incumbents to combine unbundled facilities for the benefit of their competitors. The court concluded that, even if a new entrant without any facilities of its own can purchase all the network elements needed to provide a finished service, the use of network elements was still distinct from resale for two reasons. First, new entrants must bear the cost and risk of physically combining the elements themselves. Second, while a carrier may purchase services for resale on demand, on a unit-by-unit basis, a carrier using unbundled access must make an up-front investment to pay for all the required network elements. This up-front investment, the court concluded, entails another risk that is not associated with resale.

Petitioners want to reopen the narrow question whether an incumbent can be required to sell its end-to-end facilities on a pre-combined, bundled basis, without placing before this Court the underlying question whether a competitor's use of the incumbent's full network to sell retail service constitutes purchase of unbundled network elements at all, or rather resale of the incumbent's retail service. If the Court decides to review the partial unbundling question presented as Question Two in the FCC's petition, then it should also review the full issue actually implicated by those petitions and decided by the Eighth Circuit.[2]

1. The 1996 Act. In the 1996 Act, Congress provided three separate methods of entry from which new entrants could choose. First, a competitor may construct its own network and "interconnect" with the incumbent LEC "for the transmission and routing" of traffic between the two networks. 47 U.S.C. § 251(c)(2). As the FCC explained, a new entrant that builds a local network "will need an agreement with the incumbent LEC to enable the entrant's customers to place calls to and receive calls from the incumbent LEC's subscribers." Pet. App. 138a.

Second, Congress required incumbent LECs to offer competitors "access to network elements on an unbundled basis." 47 U.S.C. § 251(c)(3). Although Congress sought to encourage "meaningful facilities-based competition" wherever feasible, it recognized that "it is unlikely that competitors will have a fully redundant network in place" when they first seek to compete. S. Conf. Rep. No. 104-230, at 148 (1996) ("Conference Report"); *see* H.R. Rep. No. 104-204, at 77 (1995) ("House Report"). For instance, cable television companies planned to use their existing door-to-door networks to carry telephone

---

[2] The same issue is also raised as Question Two in AT&T's petition (No. 97-826) and as Question One in MCI's petition (No. 97-829). The ALTS petition (No. 97-830) does not challenge this aspect of the Eighth Circuit's decision.

calls as well as TV signals, but they lacked the switches needed to direct calls from one customer to another. *See* Conference Report at 148. Other carriers were installing local telephone switches, but would need to buy the wires (known as "local loops") needed to connect those switches to individual homes and businesses. To address such needs, section 251(c)(3) enables competitors to obtain individual piece-parts of the incumbent's network for use in providing their own services.

Third, Congress required incumbent LECs "to offer for resale at wholesale rates any telecommunication service that the carrier provides at retail to subscribers who are not telecommunications carriers." 47 U.S.C. § 251(c)(4). Resale permits entry by potential competitors who have no facilities of their own, or who might want to offer service beyond the area served by their existing networks. Such carriers frequently "enter by relying at first entirely on resale of the incumbent's services and then gradually deploying their own facilities," a strategy "employed successfully by MCI and Sprint in the long-distance market during the 1970's and 1980's," when those companies began competing with the incumbent monopolist, AT&T. Pet. App. 138a; *see* House Report at 72 (resale provisions are "important in order for non-facilities based carriers to have an opportunity to compete in the local exchange market, in the same way it was critical initially for the early development of competition in the long distance market").[3]

---

[3] Unlike incumbent LECs under the 1996 Act, AT&T was never required to sell competitors access to unbundled pieces of its long-distance network. The FCC declined to require AT&T to unbundle because it wanted to encourage the development of alternative networks. *See, e.g.*, Notice of Proposed Rulemaking, *GTE Sprint Communications Corp., et al., Joint Petition for Expedited Rulemaking*, 50 Fed. Reg. 50316 (1985). That is precisely what happened. Even though AT&T made available *only* end-to-end long-distance services at wholesale rates, MCI and Sprint were able to "spu[r] the growth of competition in the long-distance market" by reselling and building their own facilities over time. FCC Pet. 4.

To ensure the viability of all three entry modes (interconnection of an end-to-end competing network, use of unbundled network elements, and resale) for all categories of customers, and to encourage installation of competing facilities wherever feasible, Congress established two different rate structures: one for facilities-based competitors who purchase interconnection and unbundled network elements under sections 251(c)(2) and 251(c)(3), and another for competitors who resell the incumbent's services under section 251(c)(4).

The reason for the different pricing regimes lies in State pricing of retail local telephone services. Under State regulation "businesses pay more on a per-line basis for basic local service than do residential customers, although the costs of providing business and residential lines are generally the same." Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, 8784, ¶ 11 (1997) ("*Universal Service Order*"). Likewise, "high-density (urban) areas, where costs are typically lower, subsidize low-density (rural) areas," because States typically require LECs to charge the same price for a given business or residential service everywhere in a State without regard to these cost differences. *Id.* The "business-to-residential subsidy" and "urban-to-rural subsidy" mean that some customers (notably rural and residential customers) pay retail rates well below the actual costs of their service, while other customers (particularly urban businesses) pay rates above the cost of providing them service. By offsetting losses from serving the subsidized customers with revenues from serving the subsidizing customers, the incumbent LEC is able to recover its overall costs. *Id.*

When State regulators controlled competitive entry, such rate policies were sustainable. But, by opening the local exchange to competition through the 1996 Act, Congress created a new set of potential problems. *See* Pet. App. 133a-34a. For example, if new entrants could buy

services from the incumbent LEC at or near the incumbent's cost, for resale to the incumbent's current customers, those competitors would enjoy a virtually guaranteed profit for sales to urban business customers who pay the incumbent's artificially high retail rates. Conversely, resellers would make no effort to serve rural residential customers if wholesale rates were based on cost, because the incumbent often must set its retail rates below cost. The incumbent would therefore lose its profitable customers but would be left with its unprofitable ones—and would have no way to recover its losses. Moreover, competitors would be reluctant to incur the investment risk of deploying new technologies and facilities if they could obtain the incumbent's services at cost-based rates and earn nearly risk-free profits.

Congress therefore crafted distinct pricing requirements for each entry alternative. Where a competitor chooses to interconnect its existing facilities with the incumbent LEC's network pursuant to section 251(c)(2), or to use unbundled network elements ordered from the incumbent under section 251(c)(3) to fill in the gaps in its existing facilities, the competitor is entitled to cost-based rates. 47 U.S.C. § 252(d)(1) (incumbent's rates for interconnection and network elements "shall be based on the cost . . . of providing the interconnection or network element" plus "a reasonable profit"). By basing the prices for individual elements on the incumbent's cost, this pricing standard sends the proper economic signals to competitors who are considering whether to deploy their own facilities. If a new entrant can deploy facilities or equipment at a lower cost than the incumbent, it will have an incentive to do so.[4] Such cost-based rates for network elements also facilitate the construction of new networks

[4] *See* Cross-Pet. App. 15a ("New entrants should make their decisions whether to purchase unbundled network elements or to build their own facilities based on the relative economic costs of these options.").

on a piece-by-piece basis, because competitors who do not yet have an end-to-end network can obtain the particular items they need from the incumbent without paying an unreasonable premium.

To promote resale competition for all types of customers, however, legislators decided that "the resale rate should reflect whether, and to what extent, the local dialtone service is subsidized by other services." House Report at 72. The Act's resale provisions therefore "tak[e] into account the rate at which a local service is tariffed in a particular state." *Id.* Section 252(d)(3) requires resale rates to be based on "retail rates charged to subscribers, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier" when it sells the services to a reseller instead of a retail customer. 47 U.S.C. § 252(d)(3). Under this formula, resellers are able to compete effectively against the incumbent so long as they sell the incumbent's services more efficiently, no matter what the retail rate or its relationship to the incumbent's total costs of providing service.

2. The FCC's Regulations. In drawing up rules to implement this regime, the FCC placed a premium on quick entry into local markets, even at the cost of discouraging the facilities-based competition Congress wanted to encourage. Through three related rules the FCC essentially gutted Congress's carefully drawn distinctions between facilities-based competition and resale, predictably undermining Congress's intent to promote deployment of new networks when it is economically efficient to do so.

First, the Commission held that a competitor without *any* existing facilities of its own need not rely upon the Act's resale provisions, but rather may purchase from the incumbent LEC the entire gamut of unbundled network elements the incumbent uses to provide its end-to-end retail services. Pet. App. 242a-49a.

Second, the FCC went on to decide that competitors also could demand that the incumbent furnish all of the elements needed to provide retail services on a pre-combined, bundled basis. Pet. App. 294a. Sections 51.315(b)-(f) of the FCC's rules gave competitors the option either to purchase an incumbent LEC's retail services at the wholesale, avoided-cost rate Congress established for resale, or to buy the same services at the cost-based rates for network elements, without even having to do the work of combining the elements purchased from the incumbent.

Third, the FCC granted competitors a special right to obtain so-called "vertical services"—optional, software-based services such as caller ID, call waiting, and call forwarding—*either* at the cost-based rates for network elements *or* at the wholesale discount for resale. State regulators set incumbent LECs' retail rates for these vertical services high to "subsidize basic local service" that all customers need to use their phones.[5] The FCC held that, although vertical services are "sold directly to end users as retail services," competitors nonetheless may purchase these services not only on a resale basis, but also as network elements. Cross-Pet. App. 8a, 9a. Here again, the Commission's rules established "[a]nother way to resell" that erases Congress's sharp distinction between resale and facilities-based competition and discourages construction of competing telephone networks throughout the country.

3. The Eighth Circuit's Decision. On petitions for review of the FCC's Order, the Eighth Circuit vacated only one of the three sets of rules undermining the statutory distinction between facilities-based competition and resale. Pet. App. 41a-45a, 52a-60a.

The Eighth Circuit vacated as contrary to the language and structure of the Act the FCC's rules requiring in-

---

[5] *Universal Service Order*, 12 FCC Rcd at 8784, ¶11.

cumbent LECs, rather than the requesting carriers, to combine network elements. *Id.* at 52a-53a, 70a-71a. The court grounded its decision in the text of subsection 251(c)(3), which requires incumbent LECs to provide "'unbundled network elements in a manner that allows *requesting carriers to combine* such elements in order to provide such telecommunications service.'" *Id.* at 70a (quoting 47 U.S.C. § 251(c)(3)) (emphasis added by Eighth Circuit). That provision, the court explained, "unambiguously indicates that requesting carriers will combine the unbundled elements themselves." *Id.* Turning to the structure of the Act, the court of appeals further explained that "[t]o permit . . . an acquisition of already combined elements at cost based rates for unbundled access would obliterate the careful distinctions Congress has drawn in subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other." *Id.* at 71a.

Having found unsustainable Rule 51.315's requirement that incumbents combine network elements for their competitors, the Eighth Circuit used its own decision as a basis for saving the FCC's related ruling that competitors with no facilities of their own may purchase access at cost-based rates to all the network elements used to provide the incumbent's retail services. *Id.* at 53a-60a. The court acknowledged that allowing competitors to compete solely through network elements would conflict with the structure of sections 251(c)(3) and 251(c)(4) if, as the FCC contemplated, competitors also were able to receive those elements on a pre-combined, bundled basis, without any up-front investment of their own. *Id.* at 56a. But the court assumed for purposes of its analysis a fact now challenged by the FCC and its co-petitioners: that competitors would "be receiving the elements on an unbundled basis," *not* on a pre-combined basis. *Id.* "[O]ur decision requiring the requesting carriers to combine the elements themselves,"

the court explained, "increases the costs and risks associated with unbundled access as a method of entering the local telecommunications industry and simultaneously makes resale a distinct and attractive option." *Id.* at 56a-57a.

The court of appeals addressed the risk that "by being able to obtain the ability to provide services at cost under subsection 251(c)(3), competing carriers will be able" to "cherry-pick" the incumbent's profitable customers and disrupt State pricing policies. *Id.* at 54a. Again, the court of appeals sustained the FCC's approach by relying upon its invalidation of subsections 51.315(b)-(f) and the fact that competitors would have to make an up-front investment and combine network elements themselves. *Id.* at 56a. The court concluded: "Given the disadvantages of completely relying on unbundled access as a means to provide local telecommunications services, we believe that many new entrant carriers will choose to resell such services under subsection 251(c)(4). Consequently, we do not believe that incumbent LECs will lose all of the customers to whom they charge higher prices in order to fulfill their current universal service obligations." *Id.* at 57a.

Finally, the Eighth Circuit responded to fears that "the FCC's view of subsection 251(c)(3) allows carriers to circumvent the Act's restriction on joint marketing of local and long-distance services contained in subsection 271(e)(1)." *Id.* at 55a.[6] The Eighth Circuit dismissed this problem on the basis that, "[g]iven the downsides of enter-

[6] Section 271(e)(1) prohibits AT&T, MCI, and Sprint from marketing their own long-distance services together with local services purchased from an incumbent LEC under the resale provisions of section 251(c)(4), wherever the incumbent LEC is itself prohibited from selling long-distance service under 47 U.S.C. § 271. Because the restriction does not apply to marketing of local services that use unbundled network elements, the long-distance carriers could, under the FCC's view of the Act, avoid it simply by ordering end-to-end elements from the incumbent instead of services for resale.

ing the local telecommunications markets through unbundled access"—including the requirement that competitors invest in and combine any unbundled elements themselves—"we agree with the Commission's conclusion that some long-distance carriers will choose to enter local exchange markets through the resale provisions, subject to the joint marketing restriction, rather than assume the risks and burdens associated with unbundled access." *Id.* at 57a.

The Eighth Circuit also let stand the FCC's policy of treating vertical services such as caller ID and call forwarding *both* as network elements *and* as retail telecommunication services. *Id.* at 43a-45a. The Eighth Circuit explained that because these services "are provided through the switching hardware and software that are also used to transmit calls across phone lines," they are not only retail services that must be made available for resale, but also "qualify as network elements." *Id.* at 44a (citing 47 U.S.C. § 153(29) (definition of "network element")). Despite its recognition of the "careful distinctions Congress has drawn in subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other," the Eighth Circuit "believe[d] that in some circumstances a competing carrier may have the option of gaining access to features of an incumbent LEC's network through either unbundling or resale." *Compare* Pet. App. 71a *with id.* at 45a.

4. Petitions for Certiorari. The FCC, MCI, AT&T, and other parties filed petitions for certiorari seeking review of (among other things) the Eighth Circuit's decision vacating Rule 51.315(b). *See* FCC Pet. 25-28; MCI Pet. 15-23; AT&T Pet. 21-28. Cross-petitioners filed a brief in opposition to these petitions on December 18, 1997.

REASONS FOR GRANTING THE CONDITIONAL CROSS-PETITION

Cross-petitioners do not believe that the decision below is worthy of this Court's review. The decision involved a routine application of a settled standard of review to a complex agency rulemaking. Pet. App. 8a (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-45 (1984)). The Eighth Circuit recognized that it must uphold agency interpretations that are consistent with the plain meaning of a statute or that reasonably apply ambiguous legislative mandates. *Id.* (citing *Chevron*, 467 U.S. at 842-45). Applying this standard, the Eighth Circuit determined that some of the FCC's policies conflicted with the text and structure of the 1996 Act, while others did not. As explained in cross-petitioners' brief in opposition, the Eighth Circuit's holdings on the issues raised by the FCC and its co-petitioners were correct and, in any event, present a poor candidate for review by this Court. Brief in Opposition at 21-28.

But if the Court decides to review the Eighth Circuit's application of *Chevron* to the FCC's rules on combinations of network elements—Question Two in the FCC's petition—it cannot properly consider that issue in isolation. The Eighth Circuit's ruling that the Act requires competitors to combine network elements obtained from the incumbent was crucial to the court of appeals' decision that a competitor may order unbundled network elements under section 251(c)(3) even if it owns no facilities. Indeed, the Eighth Circuit expressly conditioned the latter holding on the former.

If this Court denies the petitions altogether or grants certiorari limited to the jurisdictional question raised by the FCC and its co-petitioners, then this conditional cross-petition would not come into play. But if the Court grants certiorari on the second question raised by the FCC and reviews the legality of Rule 51.315(b), the Court should grant this conditional cross-petition as well to ensure that

the full scope of the lower court's unbundling decision is properly before it.

I. IF THE COURT REVIEWS THE EIGHTH CIRCUIT'S HOLDING ON COMBINATIONS OF NETWORK ELEMENTS, IT SHOULD ALSO CONSIDER WHETHER COMPETITORS WITHOUT ANY FACILITIES MAY PURCHASE END-TO-END NETWORK ELEMENTS AS A SUBSTITUTE FOR RESALE

The FCC's rules on unbundled network elements (1) permitted entrants to pay cost-based rates even when they want to rely exclusively on the incumbent's network elements to recreate an existing end-to-end service; and (2) allowed entrants to obtain network elements already assembled by the incumbent—that is, in a fully "bundled" form—so that the entrants need do no work and incur no investment risk to combine the elements into a finished service.

The Eighth Circuit correctly recognized that together these rules, as interpreted by the FCC, "would obliterate the careful distinctions Congress has drawn in subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other." Pet. App. 71a.

AT&T, for one, made no secret that the FCC's approach would create two prices for obtaining the same service for resale, instead of the one set out in the Act. In an "Investment Community Meeting" held in March 1997, AT&T's current President announced that AT&T would use the purchase of end-to-end combinations of network elements from the incumbent as "[a]nother way to resell."[7] Using Pennsylvania as an example, Mr. Zeglis stated that, where-

---

[7] Transcript, AT&T Investment Community Meeting, at 4 (Mar. 3, 1997) (comments of John Zeglis).

as the State-wide resale discount set in accordance with the 1996 Act's avoided-cost methodology is 25.9 percent, this strategy of purchasing a "platform" of all the facilities associated with a particular service under section 251(c)(3) would allow AT&T to achieve "a discount of 52 percent" off the incumbent LEC's retail rate for a mid-volume customer and even higher discounts for a customer with large monthly bills.[8] In other words, AT&T could obtain use of the incumbent's facilities to sell the exact equivalent of the incumbent's services to the incumbent's existing customers, all at a discount about twice as large as the one Congress determined would give a reseller a fair opportunity to compete. AT&T would then have no incentive to construct competitive facilities. It could capture the incumbent's profitable customers without providing service more efficiently or investing one cent in competitive network facilities.

While incumbent LECs would bear the brunt of this unfair competition, other local competitors who have already done what Congress hoped for, and invested in local networks of their own, would suffer as well. For example, Brooks Fiber—a company that provides local service using its own networks[9]—has stated publicly that it "owe[s] a debt of gratitude to the Eighth Circuit. The fact that there will be no free ride for [long-distance] carriers seeking a cheap method of local market entry is a 'plus for our industry.'"[10] Likewise, Time Warner Communications—a cable television company that Congress identified as a potential facilities-based provider of

---

[8] *Id.* at 5-6.

[9] *See* Memorandum Opinion and Order, *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as Amended, to Provide In-Region, InterLATA Services in Michigan*, CC Dkt. No. 97-137, FCC 97-298, ¶ 65 (rel. Aug. 19, 1997).

[10] Telecommunications Reports, at 18 (Nov. 10, 1997) (quoting James Allen, CEO of Brooks Fiber Properties, Inc.).

local telephone service[11]—has explained that "the careful balance crafted by Congress would be upset and the goals of the 1996 Telecommunications Act frustrated if local entrants could undermine the comprehensive scheme of the Act by manipulating the provisions of Sections 251(c)(3) and 252(d)(1) to acquire complete services as platforms of network elements, and to have those services priced at cost rather than at wholesale rates as required by Sections 251(c)(4) and 252(d)(3) of the Communications Act."[12]

As explained in cross-petitioners' brief in opposition, the Eighth Circuit was correct that Rule 51.315(b), requiring incumbents to provide their competitors with preassembled packages of network elements, cannot be reconciled with the language and structure of the statute. This is particularly true in light of the FCC's currently effective rule allowing a new entrant, without any facilities of its own, to purchase at cost-based rates *all* the elements needed to provide a finished service. Although problematic in its own right, this "all elements rule" becomes indefensible when viewed in conjunction with the FCC's rule that allows competitors to obtain access to all the elements on a fully bundled basis. Accordingly, if the Court decides to review the Eighth Circuit's decision striking down the latter rule, it must at the same time review the court's expressly related decision affirming the former rule.[13]

---

[11] *See* Hearings Before the Telecommunications and Finance Subcommittee, House Commerce Committee, Statement of Gerald M. Levin, 104th Cong., 1st Sess. 3 (May 10, 1995).

[12] Time Warner Communications Memorandum in Support of Petitions for Rehearing, at 3 (8th Cir. Oct. 1, 1997).

[13] Another critical aspect of the Eighth Circuit's decision to allow the "all elements rule" to remain in place was its conclusion that access to all network elements would still require up-front designation of and investment in each element. *See* Pet. App. 56a. *See also id.* at 234a, 245a (FCC statements to the same effect). As

a. Recognizing that at least one of the FCC's two unbundling rules could not be sustained, the Eighth Circuit chose to vacate Rule 51.315(b) and other subsections requiring incumbents to provide pre-packaged bundles of network elements. The court correctly concluded that these rules violated the plain language of the Act as well as the overall statutory structure. As the Eighth Circuit explained, "[t]he last sentence of subsection 251(c)(3) reads, 'An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows *requesting carriers to combine* such elements in order to provide a telecommunications service.'" Pet. App. 52a-53a, 70a (quoting 47 U.S.C.A. § 251(c)(3)) (emphasis added by Eighth Circuit). The Eighth Circuit did not need to go beyond the plain text of that provision to conclude that "[t]his sentence unambiguously indicates that requesting carriers will combine the unbundled elements themselves." Pet. App. 53a, 70a.

The case against Rule 51.315(b) is even stronger, however, when viewed in light of the FCC's rule permitting the purchase of all elements needed to provide a finished service. By taking the language of subsection (c)(3) at face value—and requiring a new entrant to undertake real work and investment to combine individual elements obtained from the incumbent on a truly unbundled basis —the court of appeals was able to preserve the crucial distinction between access to unbundled network elements under section 251(c)(3) and resale under section 251(c)(4). *See* Pet. App. 56a-57a ("our decision requiring the requesting carriers to combine the elements themselves increases the costs and risks associated with unbundled access as a method of entering the local telecommunications industry and simultaneously makes resale a distinct and attractive option").

---

we shall see, however, that conclusion has itself been called into question by the FCC's subsequent decisions applying the 1996 Act. *See* pp. 20-22 & n.14, *infra*.

b. If Rule 51.315(b) were resurrected and competitors were permitted to obtain network elements on a *pre-assembled*, rather than *unbundled*, basis—particularly without any need to designate the requested network elements and pay for them in advance—then it would be impossible to sustain the FCC's rule allowing competitors without any facilities to compete solely through the purchase of unbundled network elements. In the first place, this rule could not be reconciled with the plain language of the statute. Section 251(c)(3) imposes upon incumbent LECs the "duty to provide . . . nondiscriminatory access to network elements on an unbundled basis *at any technically feasible point*." 47 U.S.C. § 251(c)(3) (emphasis added). The provision enables competitors to select the point or points on an incumbent's network where they require access in order to make use of individual network elements. Section 251(c)(6) reinforces this intent by imposing on incumbent LECs the duty to provide for "physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier," thereby enabling the competitor to connect its facilities at the appropriate point to those of the incumbent LEC. 47 U.S.C. § 251(c)(6). Under the FCC's end-to-end elements rule, however, access "at any technically feasible point" would become a fiction; competitors without any facilities would take the *entire* end-to-end network at cost-based rates without connecting to the incumbent's network at *any* point of access or even connecting the pieces of the incumbent's network to each other.

The 1996 Act's legislative history confirms that Congress never intended this end-to-end use of unbundled elements. Rather, Congress intended to provide a way for *facilities-based* competitors to supplement their own network equipment. Legislators drew a sharp distinction between a "competitor offering service exclusively through the resale" of an incumbent's services and one having some facilities in place. Conference Report at 148. Con-

gress "recognize[d] that it is unlikely that competitors will have a fully redundant network in place when they initially offer local service, because the investment necessary is so significant," and therefore that "[s]ome facilities and capabilities (*e.g.*, central office switching) will likely need to be obtained from the incumbent local exchange carrier as network elements pursuant to new section 251." *Id.* But Congress *never* anticipated that a competitor might obtain *all* of the facilities it needed by purchasing network elements. "Unbundled access" was a form of physical access needed to ensure "the interoperability of *both carriers' networks.*" S. Rep. No. 104-23, at 20 (1995) (emphasis added). The "duty to offer resale at economically feasible rates to the reseller," in contrast, was deemed "important in order for *non-facilities-based carriers* to have an opportunity to compete." House Report at 72 (emphasis added).

The Eighth Circuit's primary reason for concluding that the end-to-end use of unbundled elements was consistent with the statutory distinction between resale and unbundled elements was that the "increased risk and the additional cost of recombining the unbundled elements will hinder the ability of competing carriers to undercut [LEC] prices and lure [high-profit] customers away from the incumbent LECs." Pet. App. 57a. But the Eighth Circuit's rationale would be severely undercut if Rule 51.315(b) were reinstated, because there would no longer be any "recombining" by the entrant and therefore no "increased risk" or "additional cost" associated with that combining.

As an additional ground for upholding the all elements rule, the Eighth Circuit relied on the FCC's assertion that there are inherent differences between purchasing use of the incumbent's facilities and reselling the incumbent's services. According to the FCC, "[a carrier] providing services through unbundled access . . . must make

an up-front investment that is large enough to pay for the cost of acquiring access to all of the unbundled elements of an incumbent LEC's network that are necessary to provide local telecommunications services without knowing whether consumer demand will be sufficient to cover such expenditures." Pet. App. 56a; *see id.* at 245a (representing that a competitor purchasing a facility as an unbundled network element "faces the risk that end-user customers will not demand a sufficient number of services using that facility for the carrier to recoup its costs," but a "carrier that resells an incumbent LEC's services does not face the same risk").

Under the FCC's own subsequent application of the 1996 Act, however, competitors are *not* required to make the up-front investment originally identified by the FCC and on which the Eighth Circuit relied. Generally speaking, local telephone networks can be divided into three segments: (1) the local loop, which connects an individual customer to a central telephone switch; (2) the switch, which directs calls to their destination; and (3) the trunk connections between switching centers, which transport calls that originate and terminate in areas served by different switches. With respect to unbundling of switching and trunks under section 251(c)(3), the FCC has held that competitors may "share" the incumbents' entire collection of switches and trunks, without specifying in advance the particular switches and trunks they wish to use and without paying for anything more than they actually use.[14] According to the Commission, the

---

[14] *See* Third Order on Reconsideration and Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 12 FCC Rcd 12460, 12485-86, ¶¶ 43-44 (1997) (*"Shared Transport Order"*). The Eighth Circuit is currently considering several petitions for review of the FCC's order. *See Southwestern Bell Telephone Co. v. FCC*, No. 97-3389 (and consolidated cases) (oral argument scheduled for Jan. 15, 1998). The pendency of that case weighs against any grant of certiorari on the narrow unbundling question raised in the peti-

switch and transport facilities of the incumbent should, at the competitor's option, be "priced based on actual usage," such that the competitor need not make up-front investments or risk fluctuations in demand. Response of Federal Respondents to Petitions for Rehearing, *Iowa Utils. Bd. v. FCC*, No. 96-3321, at 12, 13 (8th Cir. filed Oct. 1, 1997). Similarly, there is no risky up-front investment in the loop. Loops are purchased individually after the customer commits to using the new provider. *Id.* at 13.

The FCC argued before the court of appeals that, even if considerations of investment risk would not lead a competitor to choose resale over unbundled elements, a competitor might do so with respect to some customers for whom the State has set retail rates at artificially low levels to promote universal service. *Id.* The FCC explained that, when retail rates are low relative to costs, "the 'retail less avoided cost' standard of section 252(d)(3) will allow a new entrant to compete via resale, while access to unbundled elements at rates 'based on the cost' of those elements likely will not." *Id.*

But that, of course, is precisely the point. The FCC's rules, particularly as applied in its subsequent *Shared Transport Order*, would allow new entrants to engage in regulatory arbitrage—invoking the resale pricing rules when those are advantageous, and the network element rules when those are advantageous—without any substantive difference in the service provided, the work done, or the up-front investment made by the new entrant. The

---

tions of the FCC and the interexchange carriers. Even if, as the petitioners contend, network elements must be economically, but not physically, unbundled, their concept of a "network element platform" (which can be accessed on an "as needed" basis with no designation of, and no up-front investment in, individual network elements) is still inconsistent with the Eighth Circuit's holding and with the distinction Congress drew between resale and the use of unbundled elements. Cross-petitioners anticipate that the Eighth Circuit's decision on the *Shared Transport Order* will make this clear.

fact that the resale provisions of section 251(c)(4) provide a more favorable path for potential competitors in some instances does not justify creating a new extra-statutory pricing regime to address other situations in which end-to-end use of network elements is more expedient.

In sum, if the Court were to grant certiorari to consider the terms and conditions of furnishing network elements under section 251(c)(3), it should review not only the FCC's rule allowing competitors to order combinations of network elements, but also the Commission's decision allowing competitors to order end-to-end network elements. The Court could not sustain both rules without jeopardizing the critical statutory distinction between resale and the purchase of unbundled network elements.

II. IF THE COURT REVIEWS THE RELATIONSHIP BETWEEN NETWORK ELEMENTS AND RESALE, IT SHOULD ALSO CONSIDER WHETHER COMPETITORS MAY ORDER RETAIL VERTICAL SERVICES AS NETWORK ELEMENTS

Another rule the Eighth Circuit let stand also reflects the FCC's confusion of network unbundling with resale and likewise should be addressed if the Court takes up the proper interplay of these regimes.

As we have discussed, the Act distinguishes between "telecommunications service[s] . . . provide[d] at retail to customers who are not telecommunications carriers"—which are subject to the resale requirement and the avoided-cost discount—and "facilit[ies] or equipment used in the provision of a telecommunications service"—which are subject to the unbundling requirements of section 251(c)(3) and cost-based pricing. *Compare* 47 U.S.C. § 251(c)(4) *with id.* §§ 251(c)(3), 153(29). No one disputed below that vertical services are retail telecommunications services subject to the resale provisions of

the Act. *See* Pet. App. 45a n.29 ("the parties seem to agree that . . . caller I.D., call forwarding, and call waiting can . . . be classified as services"). Nevertheless, the Eighth Circuit agreed with the FCC that "a competing carrier may have the option of gaining access to features of an incumbent LEC's network through either unbundling or resale." *Id.* at 45a. On this view, then, vertical services constitute both telecommunications services (sold at the retail rate less the wholesale discount) *and* a "facility or equipment used in the provision of a telecommunications service" (available at cost-based rates). *Compare* 47 U.S.C. § 251(c)(4) *with id.* §§ 251(c)(3), 153(29). This holding is particularly significant because State regulators set retail rates for vertical services high to support low prices for other services. *Universal Service Order*, 12 FCC Rcd at 8784, ¶ 11. Thus, cost-based rates for vertical services are substantially lower than the resale rate determined in accordance with the Act. The FCC's regulation making cost-based pricing schemes available for vertical services effectively renders the Act's resale pricing provisions irrelevant for these services.

It is implausible that Congress wanted the same retail telecommunications services to be available to the incumbent LECs' competitors at two different prices, particularly where the resale rate—which clearly applies—would be nullified. Rather than considering the practical consequences of the FCC's approach, however, the court of appeals simply determined that some LEC operations might qualify as network elements regardless of whether they also could be labeled "telecommunications services." Pet. App. 42a-43a.

The court explained that "the Act's definition of network elements is not limited to only the physical components of a network that are directly used to transmit a phone call from point A to point B," but also includes the "technology and information used to facilitate order-

ing, billing and maintenance of phone service." *Id.* at 42a. The court directed this reasoning principally at incumbent LECs' operations support systems, used for such tasks as processing customer orders and bills. But even if the Eighth Circuit were correct that these support systems and their functions can be classified alternately as "telecommunications services" and "unbundled network elements," it would not follow that *retail* telecommunications services covered by the resale provisions of section 251(c)(4) also may be purchased as unbundled network elements under section 251(c)(3). Thus, the Eighth Circuit erred when it declared: "Our agreement with the FCC's determination that the Act broadly defines the term 'network element' " to include wholesale operations support systems "leads us also to agree with the Commission's conclusion that operator services, directory assistance, caller I.D., call forwarding, and call waiting are network elements that are subject to unbundling." *Id.* at 44a.

More fundamentally, the Act defines a "network element" as a "facility or equipment *used* in the provision of a telecommunications service." 47 U.S.C. § 153(29) (emphasis added). Caller ID, call forwarding, call waiting, and other vertical services are all themselves telecommunications services because they are offered for a fee directly to the public. See 47 U.S.C. § 153(46) ("The term 'telecommunications service' means the offering of telecommunications for a fee directly to the public . . ."). Vertical services are not "used in the provision of a telecommunications service." They *are* telecommunications services and, as such, cannot be network elements. Network elements and retail services are, by definition, different, and it is upon that difference that the viability of Congress's discrete statutory schemes for resale and use of unbundled network elements depends.

CONCLUSION

The rules that the Eighth Circuit sought to salvage, just like the rules it struck down, "would obliterate the careful distinctions Congress has drawn in subsections 251(c)(3) and (4) between access to unbundled network elements on the one hand and the purchase at wholesale rates of an incumbent's telecommunications retail services for resale on the other." Pet. App. 71a. If the Court reviews any one of these FCC rules, it should review and strike down all three. This conditional cross-ptition accordingly should be granted if the Court grants review of Question Two in the FCC's petition.

Respectfully submitted,

LAURENCE H. TRIBE
JONATHAN S. MASSEY
1575 Massachusetts Avenue
Cambridge, Massachusetts 02138
(617) 495-4621

WALTER H. ALFORD
WILLIAM B. BARFIELD
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Suite 1800
Atlanta, Georgia 30367
(404) 249-2600
Counsel for
BellSouth Corporation

MARK L. EVANS *
MICHAEL K. KELLOGG
AUSTIN C. SCHLICK
SEAN A. LEV
JONATHAN T. MOLOT
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1301 K Street, N.W.
Suite 1000 West
Washington, D.C. 20005
(202) 326-7900
Counsel for
Ameritech Corporation,
Bell Atlantic Corporation,
BellSouth Corporation, and
SBC Communications Inc.

* Counsel of Record

December 24, 1997

KELLY R. WELSH
JOHN T. LENAHAN
AMERITECH CORPORATION
30 South Wacker Drive
Chicago, Illinois 60606
(312) 750-5000

KENNETH S. GELLER
DONALD M. FALK
MAYER, BROWN & PLATT
2000 Pennsylvania Ave., N.W.
Suite 6500
Washington, D.C. 20006
(202) 463-2000

STEPHEN M. SHAPIRO
THEODORE A. LIVINGSTON
JOHN E. MUENCH
MAYER, BROWN & PLATT
190 South LaSalle Street
Chicago, Illinois 60603
(312) 782-0600

Counsel for
Ameritech Corporation

JAMES R. YOUNG
EDWARD D. YOUNG III
MICHAEL E. GLOVER
BELL ATLANTIC CORPORATION
1320 North Court House Road
Eighth Floor
Arlington, Virginia 22201
(703) 974-2944

Counsel for
Bell Atlantic Corporation

JAMES D. ELLIS
PATRICIA DIAZ DENNIS
ROBERT M. LYNCH
LIAM S. COONAN
MARTIN E. GRAMBOW
DAVID F. BROWN
SBC COMMUNICATIONS INC.
175 E. Houston, Room 1254
San Antonio, Texas 78205
(210) 351-3737

DURWARD D. DUPRE
MICHAEL J. ZPEVAK
SOUTHWESTERN BELL
TELEPHONE COMPANY
One Bell Plaza, Room 2401
Dallas, Texas 75202
(214) 464-5550

STEPHEN B. HIGGINS
JAMES W. ERWIN
THOMPSON COBURN
One Mercantile Center
Suite 3500
St. Louis, Missouri 63101-1693
(314) 552-6054

Counsel for
SBC Communications Inc.

APPENDIX

APPENDIX A

FCC 96-325

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

CC Docket No. 96-98

IN THE MATTER OF

IMPLEMENTATION OF THE LOCAL COMPETITION PROVISIONS IN THE TELECOMMUNICATIONS ACT OF 1996

CC Docket No. 95-185

INTERCONNECTION BETWEEN LOCAL EXCHANGE CARRIERS AND COMMERCIAL MOBILE RADIO SERVICE PROVIDERS

FIRST REPORT AND ORDER

Adopted: August 1, 1996 Released: August 8, 1996

* * * *

C. Economic Barriers

10. As we pointed out in our Notice of Proposed Rulemaking in this docket,[3] the removal of statutory and

[3] *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Notice of Proposed Rulemaking, FCC 96-182 (rel. Apr. 19, 1996), 61 Fed. Reg. 18311 (Apr. 25, 1996) (NPRM).

regulatory barriers to entry into the local exchange and exchange access markets, while a necessary precondition to competition, is not sufficient to ensure that competition will supplant monopolies. An incumbent LEC's existing infrastructure enables it to serve new customers at a much lower incremental cost than a facilities-based entrant that must install its own switches, trunking and loops to serve its customers.[4] Furthermore, absent interconnection between the incumbent LEC and the entrant, the customer of the entrant would be unable to complete calls to subscribers served by the incumbent LEC's network. Because an incumbent LEC currently serves virtually all subscribers in its local serving area,[5] an incumbent LEC has little economic incentive to assist new entrants in their efforts to secure a greater share of that market. An incumbent LEC also has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions for terminating calls from the entrant's customers to the incumbent LEC's subscribers.

11. Congress addressed these problems in the 1996 Act by mandating that the most significant economic impediments to efficient entry into the monopolized local market must be removed. The incumbent LECs have economies of density, connectivity, and scale; traditionally, these have been viewed as creating a natural monopoly. As we pointed out in our NPRM, the local competition provisions of the Act require that these economies be shared with entrants. We believe they should be shared in a way that permits the incumbent LECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost-based prices.[6] Congress also

---

[4] *See* NPRM at para. 6.

[5] *See* NPRM at n.13.

[6] *See* NPRM at paras. 10-12.

recognized that the transition to competition presents special considerations in markets served by smaller telephone companies, especially in rural areas.[7] We are mindful of these considerations, and know that they will be taken into account by state commissions as well.

12. The Act contemplates three paths of entry into the local market—the construction of new networks, the use of unbundled elements of the incumbent's network, and resale. The 1996 Act requires us to implement rules that eliminate statutory and regulatory barriers and remove economic impediments to each. We anticipate that some new entrants will follow multiple paths of entry as market conditions and access to capital permit. Some may enter by relying at first entirely on resale of the incumbent's services and then gradually deploying their own facilities. This strategy was employed successfully by MCI and Sprint in the interexchange market during the 1970's and 1980's. Others may use a combination of entry strategies simultaneously—whether in the same geographic market or in different ones. Some competitors may use unbundled network elements in combination with their own facilities to serve densely populated sections of an incumbent LEC's service territory, while using resold services to reach customers in less densely populated areas. Still other new entrants may pursue a single entry strategy that does not vary by geographic region or over time. Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy. Moreover, given the likelihood that entrants will combine or alter entry strategies over time, an attempt to indicate such a preference in our section 251 rules may have unintended and undesirable results. Rather, our obligation in this proceeding is to establish rules that will ensure that all pro-competitive entry

---

[7] 47 U.S.C. § 251(f).

strategies may be explored. As to success or failure, we look to the market, not to regulation, for the answer.

13. We note that an entrant, such as a cable company, that constructs its own network will not necessarily need the services or facilities of an incumbent LEC to enable its own subscribers to communicate with each other. A firm adopting this entry strategy, however, still will need an agreement with the incumbent LEC to enable the entrant's customers to place calls to and receive calls from the incumbent LEC's subscribers.[8] Sections 251(b)(5) and (c)(2) require incumbent LECs to enter into such agreements on just, reasonable, and nondiscriminatory terms and to transport and terminate traffic originating on another carrier's network under reciprocal compensation arrangements. In this item, we adopt rules for states to apply in implementing these mandates of section 251 in their arbitration of interconnection disputes, as well as their review of such arbitrated arrangements, or a BOC's statement of generally available terms. We believe that our rules will assist the states in carrying out their responsibilities under the 1996 Act, thereby furthering the Act's goals of fostering prompt, efficient, competitive entry.

14. We also note that many new entrants will not have fully constructed their local networks when they begin to offer service.[9] Although they may provide some of their own facilities, these new entrants will be unable to reach all of their customers without depending on the incumbent LEC's network, entrants will likely need agreements that enable them to obtain wholesale prices for services they wish to sell at retail and to use at least some portions of the incumbents' facilities, such as local loops and end office switching facilities.

---

[8] *See infra*, Section IV.A.

[9] Joint Managers' Statement, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 113 (1996) ("Joint Explanatory Statement") at 121.

15. Congress recognized that, because of the incumbent LEC's incentives and superior bargaining power, its negotiations with new entrants over the terms of such agreements would be quite different from typical commercial negotiations. As distinct from bilateral commercial negotiation, the new entrant comes to the table with little or nothing the incumbent LEC needs or wants. The statute addresses this problem by creating an arbitration proceeding in which the new entrant may assert certain rights, including that the incumbent's prices for unbundled network elements must be "just, reasonable and nondiscriminatory." [10] We adopt rules herein to implement these requirements of section 251(c)(3).

* * * *

3. Discussion

258. We adopt the concept of unbundled elements as physical facilities of the network, together with the features, functions, and capabilities associated with those facilities. Carriers requesting use of unbundled elements within the incumbent LEC's network seek in effect to purchase the right to obtain exclusive access to an entire facility, or use of some feature, function or capability of that element. For some elements, especially the loop, the requesting carrier will purchase exclusive access to the element for a specific period, such as on a monthly basis. Carriers seeking other elements, especially shared facilities such as common transport, are essentially purchasing access to a functionality of the incumbent's facilities on a minute-by-minute basis. This concept of network elements, as discussed *infra* at section V.G., does not alter the incumbent LEC's physical control or ability or duty to repair and maintain network elements.

259. We conclude that we should identify a particular facility or capability, for example, as a single network element, but allow ourselves and the states (where appro-

---

[10] *See* 47 U.S.C. § 251(c)(3).

priate) the discretion to further identify, within that single facility or capability, additional required network elements. Thus, for example, in this proceeding, we identify the local loop as a single network element.[553] We also ask the states to evaluate, on a case-by-case basis, whether to require access to subloop elements, which can be facilities or capabilities within the local loop.[554] We agree with those commenters that argue that identifying a particular facility or capability as single network element, but allowing such elements to be further subdivided into additional elements, will allow our rules (as well as the states) to accommodate changes in technology, and thus better serve the interests of new entrants and incumbent LECs, and the procompetitive purposes of the 1996 Act.[555] We are not persuaded by PacTel's argument that it is unnecessary for our rules to permit the identification of additional elements, beyond those specifically referenced in parts of the 1996 Act, because our rules must conform to the definition of a network element, and they must accommodate changes in technology. Nor are we persuaded by BellSouth that identification of network elements should be left solely to the parties. We reject this approach for the same reasons that led us to adopt national unbundling requirements.[556] Finally, we agree with NYNEX and others that we should not identify elements in rigid terms, but rather by function.

260. We agree with MCI and MFS that the definition of the term network element includes physical facilities, such as a loop, switch, or other node, as well as logical features, functions, and capabilities that are provided by, for example, software located in a physical facility such

---

[553] *See infra*, Section V.J.

[554] *Id.*

[555] *See, e.g.*, District of Columbia Commission comments at 21-22; MFS comments at 36.

[556] *See supra*, Sections II.A, II.B, V.B.

as a switch.[557] We further agree with MCI that the embedded features and functions within a network element are part of the characteristics of that element and may not be removed from it. Accordingly, incumbent LECs must provide network elements along with all of their features and functions, so that new entrants may offer services that compete with those offered by incumbents as well as new services.

261. The only limitation that the statute imposes on the definition of a network element is that it must be "used in the provision of a telecommunications service." [558] Incumbent LECs provide telecommunications services not only through network facilities that serve as the basis for a particular service, or that accomplish physical delivery, but also through information (such as billing information) that enables incumbents to offer services on a commercial basis to consumers. Our interpretation of the term "provision" finds support in the definition of the term "network element." That definition provides that the type of information that may constitute a feature or function includes information "used in the transmission, routing or other provision of a telecommunications service." [559] Since "transmission" and "routing" refer to physical delivery, the phrase "or other provision of a telecommunications service" goes beyond mere physical delivery.

262. We conclude that the definition of the term "network element" broadly includes all "facilit[ies] or equipment used in the provision of a telecommunications service," and all "features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecom-

---

[557] MCI comments at 27-28; MFS comments at 36-37.

[558] 47 U.S.C. § 153(29).

[559] *Id.*

munications service." [560] This definition thus includes, but is not limited to, transport trunks, call-related databases, software used in such databases, and all other unbundled elements that we identify in this proceeding.[561] The definition also includes information that incumbent LECs use to provide telecommunications functions commercially, such as information required for pre-ordering,[562] ordering, provisioning,[563] billing, and maintenance and repair services. This interpretation of the definition of the term "network element" will serve to guide both the Commission and the states in evaluating further unbundling requirements beyond those we identify in this proceeding.

263. We disagree with those incumbent LECs which argue that features that are sold directly to end users as retail services, such as vertical features, cannot be considered elements within incumbent LEC networks.[564] If we were to conclude that any functionality sold directly to end users as a service, such as call forwarding or caller ID, cannot be defined as a network element, then incumbent LECs could provide local service to end users by selling them unbundled loops and switch elements, and thereby entirely evade the unbundling requirement in section 251(c)(3).[565] We are confident that Congress did not intend such a result. We further reject Ameritech's argument that we should not permit carriers to use unbundled elements to provide services that are priced above

---

[560] *Id.*

[561] *See infra*, V.J.

[562] *See infra*, Section V.J.5, for a definition of pre-ordering services.

[563] The term "provisioning" includes installation.

[564] *See infra*, Section V.J, discussing vertical features and noting that the Illinois Commission has rejected arguments that vertical features cannot be incorporated into network elements.

[565] *See, e.g.*, CompTel reply at 20-22.

cost at retail. We agree with those parties that argue that competition will not develop if we find that supracompetitive pricing is protected by the 1996 Act.[566]

264. Moreover, we agree with those commenters that argue that network elements are defined by facilities or their functionalities or capabilities, and thus, cannot be defined as specific services. A single network element could be used to provide many different services. For example, a local loop can be used to provision inter- and intrastate exchange access services, as well as local exchange services. We conclude, consistent with the findings of the Ohio and Oregon Commissions, that the plain language of section 251(c)(3) does not obligate carriers purchasing access to network elements to provide all services that an unbundled element is capable of providing or that are typically offered over that element.[567] Section 251(c)(3) does not impose any service-related restrictions or requirements on requesting carriers in connection with the use of unbundled elements.

* * * *

c. Discussion

(1) Local Switching Capability

410. We conclude that incumbent LECs must provide local switching as an unbundled network element. The record supports a finding that it is technically feasible for incumbent LECs to provide access to an unbundled local switching element, and that denying access to a local switching element would substantially impair the ability of many competing carriers to provide switched telecommuni-

---

[566] *See, e.g.*, DoJ reply at 23-31; CompTel reply at 13-22. For a discussion of the argument that allowing new entrants to purchase vertical features as unbundled elements would nullify section 251(c)(4), *see infra*, Section V.H.

[567] Ohio Commission comments at 33; Oregon Commission comments at 27.

cations services. We also note that section 271 requires BOCs to offer or provide "[l]ocal switching unbundled from transport, local loop transmission, or other services" as a precondition to providing in-region interLATA services.[907] As discussed below, we identify a local switching element that includes the basic function of connecting lines and trunks as well as vertical switching features, such as custom calling and CLASS features.[908] We agree with the Illinois Commission that defining the switching element in this way will permit competitors to compete more effectively by designing new packages and pricing plans.[909]

411. In the United States, there are over 23,000 central office switches, the vast majority of which are operated by incumbent LECs.[910] It is unlikely that consumers would receive the benefits of competition quickly if new entrants were required to replicate even a small percentage of incumbent LECs' existing switches prior to entering the market. The Illinois Commission staff presented evidence in a recent proceeding indicating that it takes between nine months and two years for a carrier to purchase and install a switch.[911] We find this to be persuasive evidence of the

---

[907] 47 U.S.C. § 271(c)(2)(B)(vi).

[908] Custom calling features, such as call waiting, three-way calling, and call forwarding, are switch-based calling functions. CLASS features, such as caller ID, are number translation services that are based on the availability of interoffice signaling.

[909] *AT&T Communications of Illinois, Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act*, Order, Docket Nos. 95-0458 and 95-0531, June 26, 1996 (Illinois Wholesale Order) at 63-66.

[910] *Statistics of Communications Common Carriers*, Federal Communications Commission, 1994/1995 Edition, at Table 2.4. This figure is derived from carriers filing with the FCC, which represent approximately 92 percent of the industry.

[911] Supplemental Rebuttal Testimony of Jake Jennings, Office of Policy and Planning, Illinois Commerce Commission, ICC Staff Ex. 1.04, Docket No. 95-0458, at 11-12 (Mar. 11, 1996).

entry barrier that would be created if new entrants were unable to obtain unbundled local switching from the incumbent LEC. The ability to purchase unbundled switching will also promote competition in an area until the new entrant has built up a sufficient customer base to justify investing in its own switch. We expect that the availability of unbundled local switching is likely to increase the number of carriers that will successfully enter the market, and thus should accelerate the development of local competition.

412. We define the local switching element to encompass line-side and trunk-side facilities plus the features, functions, and capabilities of the switch.[912] The line-side facilities include the connection between a loop termination at, for example, a main distribution frame (MDF), and a switch line card.[913] Trunk-side facilities include the connection between, for example, trunk termination at a trunk-side cross-connect panel and a trunk card. The "features, functions, and capabilities" of the local switch include the basic switching function of connecting lines to lines, lines to trunks, trunks to lines, trunks to trunks. It also includes the same basic capabilities that are available to the incumbent LEC's customers, such as a telephone number, directory listing, dial tone, signaling, and access

---

[912] The NPRM used the terms "switch platform" and "port," as they had been developed by the Illinois and New York Commissions, respectively, to describe two possible approaches to establishing an unbundled local switching element. Parties commenting on the unbundled switching element attributed a variety of functionalities to each of these terms. To avoid confusion, we will not use these terms in discussing the unbundled local switching element. Instead, we will address commenters' proposals according to the functionality that they recommend be included in the definition of an unbundled local switching element.

[913] A line card is a plug-in electronic printed circuit card that operates ringing, holding, and other features associated with one or several telephone lines.

to 911, operator services, and directory assistance.[914] In addition, the local switching element includes all vertical features that the switch is capable of providing, including custom calling, CLASS features, and Centrex, as well as a..y technically feasible customized routing functions. Thus, when a requesting carrier purchases the unbundled local switching element, it obtains all switching features in a single element on a per-line basis. A requesting carrier will deploy individual vertical features on its customers' lines by designating, via an electronic ordering interface, which features the incumbent LEC is to activate for particular customer lines.

413. We disagree with commenters who argue that vertical switching features should be classified exclusively as retail services, available to competing providers only through the resale provision of section 251(c)(4).[915] The 1996 Act defines network element as "a facility or equipment used in the provision of a telecommunications service" and "the features, functions, and capabilities that are provided by means of such facility or equipment."[916] Vertical switching features, such as call waiting, are provided through operation of hardware and software comprising the "facility" that is the switch, and thus are "features" and "functions" of the switch.[917] We note that the

---

[914] Purchasing the local switching element does not entitle a requesting carrier to connect its own AIN call processing database to the incumbent LEC's switch, either directly or via the incumbent LEC's signal transfer point or database. Section V.I.4. which discusses the unbundling of incumbent LECs' signaling systems and databases. We also note that E911 and operator services are further unbundled from local switching. *See infra* Section V.I.6.

[915] Section 251(c)(4)(A) requires incumbent LECs "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers." 47 U.S.C. § 251(c)(4)(A).

[916] 47 U.S.C. § 153(29).

[917] In some cases vertical features may be provided using hardware and software external to the actual switch. In those instances,

Illinois Commission recently defined an unbundled local switching element to include vertical switching features.[918] Although we find that vertical switching features should be available to competitors through the resale provision of section 251(c)(4), we reject the view that Congress intended for section 251(c)(4) implicitly to remove vertical switching features from the definition of "network element."[919] Therefore, we find that vertical switching features are part of the unbundled local switching element.[920]

* * * *

VII. PRICING OF INTERCONNECTION AND UNBUNDLED ELEMENTS

A. Overview

618. The prices of interconnection and unbundled elements, along with prices of resale and transport and termination, are critical terms and conditions of any interconnection agreement. If carriers can agree on such prices voluntarily without government intervention, these agreements will be submitted directly to the states for approval under section 252. To the extent that the carriers, in voluntary negotiations, cannot determine the prices, state commissions will have to set those prices. The price levels set by state commissions will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* and favors one party (whether favoring incumbents or en-

---

the functionality of such external hardware and software is a separate element under section 251(c)(3), and is available to competing providers. *See infra* Section V.I.4, discussing unbundled signaling and databases.

[918] *Illinois Wholesale Order* at 63-66.

[919] *See supra* Section V.H, rejecting arguments that services available for resale under section 251(c)(4) cannot be provided via unbundled elements.

[920] *See infra* Section VII.C.2.b.2, concerning the pricing of an unbundled switching element.

trants) or, as we believe Congress intended, *pro-competition*. As discussed more fully in Section II.D. above, it is therefore critical to implementing Congress's pro-competitive, de-regulatory national policy framework to establish among the states a common, pro-competition understanding of the pricing standards for interconnection and unbundled elements, resale, and transport and termination. While such a common interpretation might eventually emerge through judicial review of state arbitration decisions, we believe that such a process could delay competition for years and require carriers to incur substantial legal costs.[1490] We therefore conclude that, to expedite the development of fair and efficient competition, we must set forth rules now establishing this common, pro-competition understanding of the 1996 Act's pricing standards. Accordingly, the rules we adopt today set forth the methodological principles for states to use in setting prices. This section addresses interconnection and unbundled elements, and subsequent sections address resale and transport and termination, respectively.

619. While every state should, to the maximum extent feasible, immediately apply the pricing methodology for interconnection and unbundled elements that we set forth below, we recognize that not every state will have the resources to implement this pricing methodology immediately in the arbitrations that will need to be decided this fall. Therefore, so that competition is not impaired in the interim, we establish default proxies that a state commission shall use to resolve arbitrations in the period before it applies the pricing methodology. In most cases, these default proxies for unbundled elements and interconnection are ceilings, and states may select lower prices. In one instance, the default proxy we establish is a price range. Once a state sets prices according to an economic cost

---

[1490] For a discussion of our legal authority to adopt national pricing rules, *see supra*, Section II.D.

study conducted pursuant to the cost-based pricing methodology we outline, the defaults cease to apply. In setting a rate pursuant to the cost-based pricing methodology, and especially when setting a rate above a default proxy ceiling or outside the default proxy range, the state must give full and fair effect to the economic costing methodology we set forth in this Order and must create a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate.

620. In the following sections, we first set forth generally, based on the current record, a cost-based pricing methodology based on forward-looking economic costs, which we conclude is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs. If market prices exceed forward-looking economic costs, new competitors will enter the market. If their forward-looking economic costs exceed market prices, new competitors will not enter the market and existing competitors may decide to leave. Prices for unbundled elements under section 251 must be based on cost under the law, and that should be read as requiring that prices be based on forward-looking economic costs. New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants' investment decisions would be distorted if the price of unbundled elements were based on embedded costs. In arbitrations of interconnection arrangements, or in rulemakings the results of which will be applied in arbitrations, states must set prices for interconnection and unbundled network elements based on the forward-looking,

long-run, incremental cost methodology we describe below. Using this methodology, states may not set prices lower than the forward-looking incremental costs directly attributable to provision of a given element. They may set prices to permit recovery of a reasonable share of forward-looking joint and common costs of network elements.[1491] In the aftermath of the arbitrations and relying on the state experience, we will continue to review this costing methodology, and issue additional guidance as necessary.

621. We reject various arguments raised by parties regarding the recovery of costs other than forward-looking economic costs in section 251(c)(2) and (c)(3) prices, including the possible recovery of: (1) embedded or accounting costs in excess of economic costs; (2) incumbent LECs' opportunity costs; (3) universal service subsidies; and (4) access charges. As discussed in Section VII.B.2.a. below, certain portions of access charges may continue to be collected for an interim period in addition to section 251(c)(3) prices.

622. With respect to prices developed under the forward-looking, cost-based pricing methodology, we conclude that incumbent LECs' rates for interconnection and unbundled elements must recover costs in a manner that reflects the way they are incurred. We adopt certain rules that states must follow in setting rates in arbitrations. These rules are designed to ensure the efficient cost-based rates required by the 1996 Act.

623. In the next section of the Order, we establish default proxies that states may elect to use prior to utilizing an economic study and developing prices using the cost-based pricing methodology. We recognize that certain states may find it difficult to apply an economic costing

---

[1491] We define these and other forward-looking cost concepts *infra*, Section VII.B.2.a. We define what we consider to be a reasonable share of forward-looking joint and common costs *infra*, Section VII.B.2.a.

methodology within the statutory time frame for arbitrating interconnection disputes. We therefore set forth default proxies that will be relatively easy to apply on an interim basis to interconnection arrangements. We discuss with respect to particular unbundled elements the reasonable rate structure for those elements and the particular default proxies we are establishing for use pending our adoption of a generic forward-looking cost model. Finally, we discuss the following additional matters: generic forward-looking costing models that we intend to examine further by the first quarter of 1997 in order to determine whether any of those models, with modifications, could serve as better default proxies; the future adjustment of rates; the relationship of unbundled element prices to retail prices; and the meaning of the statutory prohibition against discrimination in sections 251 and 252.

624. Those states that have already established methodologies for setting interconnection and unbundled rates must review those methodologies against the rules we are adopting in this Order. To the extent a state's methodology is consistent with the approach we set forth herein, the state may apply that methodology in any section 252 arbitration. However, if a state's methodology is not consistent with the rules we adopt today, the state must modify its approach. We invite any state uncertain about whether its approach complies with this Order to seek a declaratory ruling from the Commission.